Compensation

Bringing Pay for Performance Into Focus Requires the Right Lens

By Annette Leckie and Charles Grace

Savvy investors understand the value of a strong management team and are willing to pay handsomely—if company performance warrants. It's important to design executive pay to reward great performance and penalize poor performance. In our experience, most directors strive to do just that. Unfortunately, investors and other stakeholders sometimes struggle to recognize the link between pay and performance when using traditional definitions of pay.

We believe effective pay-for-performance can be demonstrated, but only if the concept of pay is viewed through the right lens. While performance can be measured many ways, the most common method is to use total shareholder return (TSR). The merits of using TSR as an incentive metric can be debated, but its use as a long-term measure of success is hard to argue. We then turn our attention to defining "pay." There are many definitions of pay, including reported, realized, and realizable pay. While each definition has its place, we believe reported and realized pay are less useful in pay-for-performance analyses. Yet these are the definitions often used by stakeholders pointing to pay and performance misalignment. The following discussion brings the best measure into focus.

Reported pay is the compensation disclosed in proxy statements. It includes salary and bonus payments earned and the value of long-term equity awards granted during the year, valued at the date of grant. Proxy advisors' analyses rely heavily on reported pay in the pay-for-performance models driving their vote recommendations. However, there is a disconnect in using reported pay in a pay-for-performance analysis. The grant-date value of equity awards does not factor in the rise or fall of stock price over the measured period, or in the final number of shares delivered. TSR, on the other hand, is defined primarily by the rise or fall in stock price. Accordingly, stock price performance is reflected on one side of the equation but not the other.

Realized pay addresses the stock price performance concern of reported pay, but is less ideal for demonstrating pay-for-performance alignment. Realized pay includes pay received during a particular year, including salary and bonus payments, the value of earned performance awards and vested time-based equity awards, and gains from stock option exercises. While realized pay is simple and reflects taxable compensation, it has limited utility when compared to TSR performance because it

1. is affected by individual decisions on when to exercise stock options;
2. could reflect multiple years of compensation depending on vesting periods and individual exercise decisions; and
3. ignores the value of equity awards that are in progress (i.e., unvested). The value of these in-progress awards is directly impacted by recent stock price performance even though pay is not realized until a later date.

While still an imperfect solution, **realizable pay** is often more effective for measuring pay-for-performance alignment. There are several ways to define realizable pay, but generally it includes salary and bonus payments earned during the measurement period (e.g., three to five years), and the value of equity awards ("spread" value for stock options) granted during the measurement period. For performance-based equity, it often includes target shares for in-progress awards, but valued at the current stock price. The advantage of using realizable pay for pay-for-performance analyses is that it shows how the value of actual and potential pay fluctuates with stock price performance over the specified period. Potential concerns include:

1. The current value of future pay may differ dramatically from the actual value realized at a later date.
2. The lack of a commonly accepted definition.
3. The lack of easily accessible disclosure of realizable compensation.

While these may be fair criticisms, we believe the merits outweigh the concerns. As emphasis on pay-for-performance increases, the case for using realizable pay to measure pay-for-performance linkage becomes clear. It is the only pay definition that aligns the impact of stock price movement on pay with TSR over the same period. Institutional investors are increasingly embracing the realizable pay approach, and it has led to greater insight on pay and performance alignment (or the lack thereof).

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